Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:TL-N-635-01
SHwang

date: MAY 10 2001

to: Office of Chief Counsel, Technical Service
Room 4510, PRE-REVIEW

from: Sandy Hwang, Attorney (LMSB) SH
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subject: [redacted]
Debt/Equity Issue
[redacted]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This is in response to your request for advice received on January 26, 2001 as to the debt/equity issue in this case. *This memorandum should not be cited as precedent.*

ISSUE

Whether the advances by taxpayer's affiliates to the taxpayer's subsidiary, [redacted], constitute capital contributions or loans for federal tax purposes.

CONCLUSION

In this case, the advances to [redacted] do not constitute true indebtedness but rather capital contributions. Accordingly, interest expense deductions taken in the amounts of $[redacted] and $[redacted] for the tax years [redacted], respectively, with respect to the purported debts should be disallowed.

FACTS[1]

[redacted] (the "taxpayer") was incorporated in Delaware on [redacted]. In [redacted], [redacted][2], a German corporation and parent of the taxpayer, purchased [redacted]. ("[redacted]"),[3] a California corporation, through a leveraged buyout and transferred the ownership of [redacted] to the taxpayer. The details of the acquisition are as follows:

As of [redacted], [redacted] entered into a Merger Agreement with [redacted], under which [redacted] agreed to acquire, via a tender offer, all the outstanding common shares of [redacted] stock for $[redacted] per share in cash, for a total purchase price of approximately $[redacted], including [redacted]'s debt. In preparation for the acquisition, [redacted] formed a new Delaware corporation, [redacted] ("Newco"). Effective on [redacted], Newco merged with [redacted], [redacted]'s common shares of stock owned by [redacted] and/or Newco were canceled, and [redacted] was the surviving entity after the merger. By virtue of this merger, [redacted] became a wholly-owned subsidiary of the taxpayer, which was a wholly-owned subsidiary of [redacted].

After its purchase, [redacted] became a private corporation and filed consolidated returns with its parent, the taxpayer, from [redacted] through [redacted]. On [redacted], as part of an internal reorganization of the taxpayer's affiliated group, the ownership of the taxpayer and [redacted] were transferred to [redacted] ("[redacted]

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[1] Our advice is contingent on the accuracy of the information which you have supplied. If you uncover any information inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

[2] [redacted] is wholly owned by [redacted] a publicly held German corporation; in turn [redacted] owned the taxpayer and [redacted], a German holding corporation. [redacted] owns [redacted] a Delaware corporation.

[3] [redacted] was a publicly held corporation and was formerly known as [redacted], which was the common parent of [redacted] consolidated group. [redacted] and its subsidiaries filed consolidated returns through the short period ended [redacted]. Subsequently, [redacted] and its subsidiaries were acquired by the taxpayer's affiliates.

[redacted]"), a Delaware corporation, located in [redacted], California. [redacted] ("[redacted]"), a Delaware corporation, are first tier subsidiaries of [redacted] ("[redacted]"), a Delaware corporation, located in New York. Starting from [redacted] the taxpayer and [redacted] were part of the [redacted] consolidated group.

[redacted]'s purchase was funded by alleged loans that the taxpayer's affiliates made to Newco in a total amount of approximately $[redacted]. [redacted] assumed the alleged indebtedness when it merged with Newco and treated the $[redacted] as indebtedness in its financial accounting records. Shortly after [redacted]'s purchase, [redacted] advanced approximately $[redacted] to [redacted]; the advances were evidenced by notes. However, these loans were not respected as true indebtedness and on [redacted], [redacted] entered into a share purchase agreement to sell its subsidiaries, including the taxpayer and [redacted], to a third party, [redacted]. ("[redacted]"). As part of the purchase agreement, it was agreed that [redacted]'s intercompany loans would be paid off.

Exam proposes to disallow interest expense deductions attributable to intercompany loans claimed by the taxpayer on its consolidated income tax returns in the amounts of $[redacted] and $[redacted] for the taxable years ended [redacted] and [redacted], respectively. The remainder of this advisory focuses on the correct tax treatment of the advances by the taxpayer's affiliates to [redacted].

Advances for [redacted]'s Acquisition

For the acquisition of [redacted] made advances to Newco on a short-term basis. This alleged indebtedness was later assumed by [redacted] upon its merger with Newco.

On or about [redacted], [redacted] advanced Newco $[redacted]. The advance was evidenced by a promissory note (the "$[redacted] Note") due in [redacted] days, i.e., its maturity date was [redacted], with an interest rate of [redacted].

On [redacted], [redacted] and Newco entered into a loan agreement, entitled the Master Agreement. *Attached as Exhibit 1 is a copy of the Master Agreement.* Under the Master Agreement, [redacted] was to extend short-term lines of credit to Newco, collateralized by a credit order issued by [redacted]. The terms of the Master Agreement provided that the Master Agreement and the lines of credit, or individual loan transactions thereunder, would be terminated if either of the following events occurred:

1) The borrower leaves the [redacted] affiliated group; or 2) A bankruptcy proceeding against the borrower was initiated. Further, the lines of credit or loan transactions were subject to termination if the borrower's financial condition deteriorated. In addition, under the Master Agreement, failure to make a payment due to reasons for which the borrower is responsible results in a default, whereby the stipulated interest rate plus one percent shall be applied until the amount due is received.

The first line of credit under the Master Agreement was obtained by Newco and was issued on [redacted] in the amount of $[redacted] ("first line of credit"), for a [redacted]-day period, with a maturity date of [redacted]. *Attached as Exhibit 2 is a copy of the Credit Line No. 1.* After [redacted] merged with Newco, [redacted] assumed all of Newco's liabilities in the aggregate amount of $[redacted], which amount included the $[redacted] Note payable to [redacted] and the balance due on the first line of credit. [redacted] took additional draws against the first line of credit. Subsequently, on [redacted], [redacted] obtained a line of credit, in the amount of $[redacted] ("second line of credit"), for a [redacted]-day period, with a maturity date of [redacted]. *Attached as Exhibit 3 is a copy of the Credit Line No. 2.* There were six draws on the two lines of credit for a total amount due of approximately $[redacted]. Each draw on the lines of credit was evidenced by a one page promissory note.

In general, while interest on the above mentioned intercompany notes was paid, [redacted] did not payoff any of the notes on their respective maturity dates. Instead, the related parties would extend the notes, cancel the notes or convert the notes on or about the notes' maturity dates into equity or new loans. The following is a detailed discussion of the parties' treatment of the $[redacted] Note and the [redacted] short-term loans (the "[redacted] Loans"):

A. <u>$[redacted] Note Converted to Equity</u>

On [redacted], the original due date, [redacted] granted a renewal of this loan, evidenced by another note with a maturity date of [redacted]. *Attached as Exhibit 4 is a copy of the reissued $[redacted] Note.* On the new due date, [redacted] the loan was transferred by [redacted] to the taxpayer, for no consideration, in order to allow the taxpayer to make a contribution of capital to [redacted]. *Attached as Exhibit 5 is a copy of [redacted]'s Board of Directors' Action by Written Consent regarding and Acknowledgment of the capital contribution.* No shares of stock were issued for this contribution. Despite the conversion of this loan to equity, the taxpayer claimed an interest deduction in the amount of $[redacted] for the $[redacted] Note in its consolidated return for the short period ended [redacted].

B. [redacted] Loans Converted to New Loans

The [redacted] Loans, which were draws, between [redacted] though [redacted], on the two lines of credit with [redacted], consisted of the following 6 short term notes, principal payable by [redacted] on [redacted], in the total amount of approximately $[redacted]:

$[redacted]	("Loan 1")
$[redacted]	("Loan 2")
$[redacted]	("Loan 3")
$[redacted]	Subtotal
$[redacted]	("Loan 4")
$[redacted]	("Loan 5")
$[redacted]	("Loan 6")
$[redacted]	Subtotal

Attached as Exhibits 6 and 7 are copies of the Loan Agreements and Promissory Notes for Loans 1 and 2, respectively. [redacted] did not pay off the above loans by [redacted], the maturity date. Instead, [redacted] transferred Loans 1-6 to its wholly owned subsidiary, [redacted]. As a result, Loans 1-6 were canceled and new loans for substantially the same aggregate amounts were issued to [redacted].

On [redacted], in lieu of short-term Loans 1-6, [redacted] issued the following new short-term and long-term loans to [redacted], in the total amount of $[redacted]:

$[redacted]	("Loan 7"), short-term, due [redacted]
$[redacted]	("Loan 8"), short-term, due [redacted]
$[redacted]	("Loan 9"), short-term, due [redacted]
$[redacted]	("Loan 10"), short-term, due [redacted]
$[redacted]	Total short-term notes
$[redacted]	("LT Loan A"), long-term
$[redacted]	("LT Loan B"), long-term
$[redacted]	("LT Loan C"), long-term
$[redacted]	Total long-term notes[4]

Again, [redacted] did not pay the short-term loans when due. [redacted] issued new short-term loans in replacement of Loans 7 and 8, and Loan 9 was canceled by combining the outstanding loan

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[4] The long-term notes were due after the years under examination between [redacted].

balance with Loan 8. On the maturity date of Loan 7, [redacted] extended the due date to [redacted] and on that due date, [redacted] converted Loan 7 into two new loans. Loan 8 was extended to [redacted] and on [redacted], Loan 8 was converted into a new loan. As of [redacted], [redacted] had the following short-term notes payable to [redacted]:

$[redacted]	("Loan 7A")
$[redacted]	("Loan 7B")
$[redacted]	("Loan 8A")
$[redacted]	(Loan 9 was canceled)
$[redacted]	(Loan 10)
$[redacted]	Total short-term notes

The above changes resulted in nothing more than extending the lives of the loans. While Loan 9, in the amount of $[redacted] was canceled and reduced to a balance of zero, Loan 8, in the amount of $[redacted] was increased by $[redacted] and reissued as Loan 8A in the amount of $[redacted]. Loan 7 in the amount of $[redacted] was converted into two smaller amounts, Loans 7A and 7B, in the amounts of $[redacted] and $[redacted], respectively. The amount of Loan 10 remained the same and was not reissued. Instead, the maturity date of Loan 10 was extended twice, first to [redacted] and then to [redacted]. Although the conversions of loans and extensions of the due dates of the short-term notes postponed payment of the loans repeatedly, [redacted] continued to fail to pay off the loans. The maturity dates of the notes were extended as follows:[5]

Loan #	Original Due Date	1st Extension Due Date	2nd Extension Due Date	3rd Extension Due Date	4th Extension Due Date	5th Extension Due Date
7A	[redacted]	[redacted]	[redacted]			
7B	[redacted]	[redacted]	[redacted]	[redacted]		
8A	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
10	[redacted]	[redacted]	[redacted]			

[5] The taxpayer and its affiliates have provided loan extension information for existing loans only for the periods under audit: years [redacted] through [redacted]. However, the taxpayer informed Exam that [redacted] was never in default on any of its loans and the loans were "renegotiated" on or about the maturity dates. Thus, we assume that the affiliates continued to extend or convert the various loans until the purchase of [redacted] by [redacted] in [redacted].

Following the conversion of Loans 7 and 8 into 7A, 7B and 8A, all existing loans with [redacted], including both short-term and long-term notes for a total amount of $[redacted] were restructured and new loan documents were issued on [redacted] to assign or transfer all existing liabilities to the taxpayer, as the middleman between [redacted]. Thus, new loan documents were issued between [redacted] as lender/assignor and taxpayer as borrower/assignee and between taxpayer as lender and [redacted] as borrower, in replacement of the loan documents between [redacted]. The new loan documents issued on [redacted] between [redacted], the taxpayer, and [redacted] were for the same amounts and terms as those notes previously issued. For example, as a result of this loan restructuring, Loan 7A existed both between [redacted] and the taxpayer and also between the taxpayer and [redacted].

In addition to postponing the payment of principal on the short-term notes by reissuing loans and/or by extending the maturity dates, the parties reshuffled the amounts of the loans. Each time the loan amounts were changed, the interest rates were revised through letters between the parties. However, no original documents have been provided to substantiate any of the changes in loan amounts. On [redacted], [redacted] extended a short-term loan to the taxpayer in the amount of $[redacted] ("Loan 11"), maturing on [redacted]. Based on the information provided by the taxpayer, Loan 11 was assigned to [redacted] on the same day [redacted] issued Loan 11. Loan 11 was not paid off. Instead, Loan 11 was terminated by increasing Loan 7B by $[redacted]. The original and amended amounts of Loans 7A, 7B, 8A, 10, and 11 are as follows:

	Loan #	Original Amount of Loan (in [redacted])	Amended Amount of Loan (in [redacted])
	7A	$[redacted]	$[redacted]
	7B	$[redacted]	$[redacted]
	8A	$[redacted]	$[redacted]
	10	$[redacted]	$[redacted]
Subtotal		$[redacted]	$[redacted]
	11	$[redacted]	$[redacted]
Total		$[redacted]	$[redacted]

Despite the fact that Loans 1, 2, and 3 were converted into Loans 7-10, which were again converted into Loans 7A, 7B, and 8A, [redacted] did not pay off any of these loans. Instead, after numerous extensions on or about the maturity dates, loan amount changes, and interest rate adjustments, these short-term notes were paid off when [redacted] purchased the taxpayer and [redacted] pursuant to a share purchase agreement entered into on [redacted]. Similarly, short-term Loans 4, 5, and 6, were converted into long-term notes, LT Loans A, B, and C, which were paid off pursuant to the share purchase agreement in [redacted]. Since these long-term notes were not due prior to [redacted]'s acquisition by [redacted], it is not clear whether the parties would have respected these long-term loans. All the changes on the notes merely resulted in designating a different member of the affiliated group as lender and extended the maturity dates of the loans so that [redacted] never had to pay off the loans. The intent of the parties to treat the loans as equity is supported in [redacted]'s [redacted] consolidated financial statements which states that while approximately $[redacted] is payable to [redacted] in [redacted], "[redacted] [[redacted]] expects to extend the terms of such debt beyond [redacted], as required." *Attached as Exhibit 8 is a copy of* [redacted]*'s* [redacted] *Notes to Consolidated Financial Statements.*

Third Party Lenders/Subordination of Intercompany Notes

Unlike the intercompany notes, [redacted]'s third party notes were respected and paid. Prior to its acquisition by [redacted], [redacted] had lines of credit with various banks with a total balance due of $[redacted]. After the acquisition, [redacted] paid off the $[redacted] with the funds advanced by its affiliates.

Additionally, [redacted] had obtained two long-term notes from [redacted] ("[redacted]") in the amounts of $[redacted] and $[redacted] ("[redacted] Notes"), issued on [redacted] and [redacted] respectively. These notes mature on [redacted] and [redacted] respectively. While these notes were not paid off before the purchase of [redacted] by [redacted] in the year [redacted], the loans from [redacted]'s affiliates were subordinated to the [redacted] Notes on [redacted]. The subordination of the intercompany notes was the agreed remedy to [redacted]'s default on the [redacted] Notes. Under the terms of the [redacted] Notes, [redacted] agreed, among other things, to maintain a ratio of Total Debt to Total Debt and Consolidated Tangible Net Worth of no more than .[redacted]. However, due to the increased amount of [redacted]'s debt caused by the acquisition debt, as of [redacted], [redacted] was in default of this and other provisions in the [redacted] Notes.

[redacted]'s default was waived by [redacted] in exchange for the subordination of [redacted]'s intercompany notes to the [redacted] Notes. On or about [redacted], in conjunction with the restructuring of all then existing loans with [redacted], in a total amount of $[redacted], the taxpayer's affiliates entered into the Affiliate Subordination Agreement, under which the following intercompany loans were subordinated to the [redacted] Notes: Loan 7A in the amount of $[redacted]; Loan 7B in the amount of $[redacted]; Loan 8A in the amount of $[redacted]; Loan 10 in the amount of $[redacted]; LT Loan A in the amount of $[redacted]; LT Loan B in the amount of $[redacted] and LT Loan C in the amount of $[redacted]. Further, [redacted] agreed to modify the definitions of "debt" and "consolidated tangible net worth" to treat the intercompany loans as equity. Unlike the original definitions, the modified definition of the consolidated tangible net worth included the subordinated intercompany debts and the definition of debt excluded the subordinated intercompany debts.

[redacted] ***Financial Condition***

The taxpayer's affiliates extended loans to [redacted] regardless of [redacted]'s financial condition. The balance sheets of the tax returns for the year ending [redacted] (prior to the acquisition of [redacted]), [redacted] (during the acquisition), and [redacted] (at the end of the first short year after the acquisition) show the following:

		(in [redacted])	
	[redacted]	[redacted]	[redacted]
Assets	[redacted]	[redacted]	[redacted]
Liabilities	[redacted]	[redacted]	[redacted]
Equity	[redacted]	[redacted]	[redacted]
Total Debt/Equity Ratio	[redacted]	[redacted]	[redacted]

[redacted]'s consolidated financial statements for the year ended [redacted] show the following, in [redacted]

Assets:	$[redacted]
Liabilities:	$[redacted]
Equity:	$[redacted]
Debt/Equity Ratio:	4[redacted]

In addition, prior to its acquisition in [redacted], [redacted]'s taxable income was approximately $[redacted]. However, due to the interest deductions claimed by [redacted] for the acquisition debts, [redacted] reported *negative* taxable income for the periods ending [redacted] and [redacted] in the amounts of approximately $[redacted] and $[redacted].

Exam proposes to disallow the interest expense deductions attributable to the acquisition debts claimed on the taxpayer's consolidated tax returns for the years ending [redacted] and [redacted] in the amounts of $[redacted] and $[redacted], respectively.

ANALYSIS

There is no singular test that courts will use in order to determine whether a loan instrument constitutes a debt or equity. Litton Business Sys., Inc. v. Commissioner, 61 T.C. 367 (1973). However, the Tax Court will look to whether there was a "genuine intention to create a debt, with a reasonable expectation of repayment, and . . . [whether] that intention comport[s] with the economic reality of creating a debtor-creditor relationship." Id. at 377.

In general, while other contemporaneous actions are examined by the courts, a taxpayer's reporting position and other financial records are probative of a taxpayer's intent. Here, the intent factor may have been superficially met because of the existence of the executed promissory notes for the $[redacted] Note and for Loans 1-7, under the lines of credit, and because these intercompany advances were reported on the taxpayer's tax returns as loans. However, the parties' actions, shortly after the acquisition, of extending, reissuing, and/or converting the loans to equity on or about the maturity dates show the parties' intent to treat the loans as equity. In addition, the parties' subordination of the intercompany loans to the [redacted] Notes and amendment of the definition of "debt" to exclude the intercompany loans show the intent of the parties to treat the intercompany debts as equity for non-tax purposes. In this case, while the taxpayer's reporting position and the characterization of the notes on its books and records for tax purposes may show some intent of treating the intercompany notes as debt, the parties' actions and treatment of the notes for non-tax purposes show a complete disregard of the form of the intercompany advances as loans.

The courts have enumerated several other factors, in addition to intent, to be considered in resolving a debt-equity issue. While the following list is not exclusive and no single factor is determinative, in the Ninth Circuit to which this case would be appealable, in addition to intent, the courts generally look to:

1. Name and presence of a written agreement demonstrating indebtedness;

2. Presence of a fixed maturity date;

3. Source of payments, e.g., whether there is anticipated cash flow to cover payments;

4. Right to enforce payment;

5. Increased participation in management as the result of the advance;

6. Subordination;

7. Thinness of the capital structure in relation to debt;

8. Identity of interest between creditor and stockholder;

9. Payment of interest only out of dividend money; and

10. Ability of the corporation to obtain credit from outside sources.

Hardman v. United States, 827 F.2d 1409, 1412 (9th Cir. 1987).

Here, there were loan documents (factor 1) which are indicative of indebtedness. It is not clear whether factor 9 has been met in this case. While [redacted] was paying interest, we do not know whether the interest payments were only out of dividend money. However, all other factors seem to indicate equity characterization.

Factor 2 exists in that the notes show a maturity date; but the parties never respected the maturity dates as fixed. Debt has been defined as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." Gilbert v. Commissioner, 248 F. 2d 399, 402 (2nd Cir. 1957). While the presence of a fixed maturity date is significant evidence of debt, the importance of this factor is vitiated when it is observed in form only. Salyes Finishing Plants, Inc. v. U.S., 399 F.2d 214, 220 (Ct. Cl. 1968). Here, the parties' actions of converting, extending, and reissuing the alleged loans on or about, and sometimes after, the maturity dates show that the maturity dates were in form only.

Under factor 3, the notes are indicative of equity. While the parties may have anticipated cash flow to pay for some of the interest payments, it would have been impossible for [redacted] to make any principal payments. As of [redacted] and [redacted], the taxpayer reported negative taxable income because of the interest expenses. At the time of issuing the acquisition debts, the parties knew or should have known that [redacted] would not have sufficient funds to pay off the short-term notes in the total amount of $[redacted] within [redacted] months of issuance, by [redacted]. Because the parties knew that [redacted] could not pay off the loans, the parties delayed the maturity dates, which shows that the parties did not realistically expect payment of the loans. Alternatively, the loan payment delays could show that the affiliates only expected payment if and when [redacted]'s financial condition improved, although, a creditor, unlike a shareholder, expects repayment in any event.

The absence of realistic creditor enforcement provisions are indicative of equity contributions (factor 4). The $[redacted] Note had no enforcement provisions and under the Master Agreement, default of a loan payment results in an increased interest rate of one percent. There were no acceleration clauses, collateral required from [redacted], or other provisions of enforcement which would be indicative of true indebtedness. In this case, the parties' actions show that they had no intention of enforcing any of the notes. It appears that the parties would only enforce the intercompany loans when [redacted] left the [redacted] group because that would cause the loan transactions to be canceled.

Factors 5, 6, 7 and 8 indicate that the notes were equity. After the acquisition debt, the taxpayer and its affiliates had control over [redacted] (factor 5). The intercompany loans were subordinated to the third party [redacted] (factor 6). All the loans from the taxpayer's affiliates were ultimately restructured to make the taxpayer, [redacted]'s parent, the sole creditor (factor 8). Factor 7 indicates that the notes may be equity because [redacted] was thinly capitalized. What constitutes a good debt/equity ratio is not clear however a 10:1 ratio is considered thin and a ratio of 4:1 or less is considered good and a safe harbor for debt characterization. See Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 496 (1980), and Gooding Amusement Co. v. Commissioner, 23 T.C. 408 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956). Yet, in Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 379 (1973), the Tax Court stated that a "good" debt/equity ratio was not a safe harbor. In this case, prior to the acquisition, the debt/equity ratio was good ([redacted]). After the acquisition debt, there was no equity in [redacted] thus the ratio was infinity. Despite the fact that [redacted] was thinly capitalized, the affiliates gave numerous loans, extensions and reissued new loans to [redacted]. Not until [redacted], when the $[redacted] Note was converted into equity, was some of the equity restored.

At the time of [redacted]'s acquisition, the taxpayer's affiliates lent to [redacted] approximately $[redacted] ($[redacted] plus $[redacted]), which is an amount almost three times greater than [redacted]'s debt prior to its acquisition and an amount in excess of [redacted]'s equity amount by approximately $[redacted] ($[redacted] less $[redacted]). [redacted] would not have been able to get such loans from a third party creditor (factor 10). As with [redacted], a third party creditor would have required [redacted] to maintain certain financial ratios before issuing loans and required [redacted] to maintain those ratios throughout the lives of the loans. While [redacted] may have been able to obtain some additional loans based on its financial standing in [redacted], it would not have been able to obtain loans in a total amount of $[redacted]. A third party creditor would not have extended loans to [redacted] with numerous extensions and conversions as in this case, especially when [redacted] had negative income with little or no equity at the time of loan issuance. As a result, the alleged loan transactions fail the economic reality test.

Considering all the factors, the $[redacted] Note and loans in the total amount of approximately $[redacted] should be treated as a contribution to capital and no interest deductions related to these alleged loans should be allowed.

This advisory opinion has been coordinated with the Office of Chief Counsel. Please call Sandy Hwang at (949)360-3432, if you have any questions.